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Supreme Court of the United States

OCTOBER TERM, 1939

No. 479

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

VS.

CHARLES A. BRUUN, RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF FOR THE RESPONDENT

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INDEX

Opinions below 1
Jurisdiction 1
Question presented 2
Constitutional Amendment and Statute Involved 2
Statement of Facts 3
Summary of Argument 4
Argument 7
Conclusion 21

CITATIONS

Cases:

Alexander v. Commissioner, 13 B.T.A. 1160 ..... 6, 18
Blatt, M.E., Co. v. United States, 23 F.Supp. 461 6
Blatt, M.E., Co. v. United States, 305 U. S. 267 ..... 2, 6, 12, 15, 16
Bourn v. McLaughlin (D.C. Cal.), 19 F.(2d) 148 150 ..... 5, 9
Burnet v. Logan, 283 U. S. 404, 413-414 ..... 5, 9
Champlin v. Commissioner (C.C.A. 10), 71 F.(2d) 23, 29 ..... 5, 9
Cleveland Trust Co. v. Commissioner, 39 B.T.A. 113 ..... 6, 18
Climer v. Wallace, 28 Mo. 556-559 ..... 5, 10
Commissioner v. Center Investment Co. (C.C.A. 9), 108 F.(2d) 190 ..... 6, 12, 18
Commissioner v. VanVorst (C.C.A. 9), 59 F.(2d) 677, 680 ..... 5, 11
Commissioner v. Wood (C.C.A. 7), 107 F.(2d) 869 ..... 5, 6, 9, 10, 12, 17
Cryan v. Wardell (N.D. Cal.), 263 Fed. 248 ..... 6, 12
Dominick v. United States (D.C. S.D. N.Y.), 24 F.Supp. 829 ..... 6, 12, 15, 16
Durkheimer Investment Co. v. Commissioner, 36 B.T.A. 423 6
Eisner v. Macomber, 252 U. S. 189, 207 ..... 4, 7, 21

Elverson Corp. v. Commissioner, 40 B.T.A. 614 21
English v. Bitgood (D.C. Conn.), 21 F.Supp. 641 ..... 6, 12, 15
Everhart v. Commissioner, 26 B.T.A. 318 ..... 5, 12
Geeseman v. Commissioner, 38 B.T.A. 258, 264 ..... 5-6, 12
Goodrich v. Edwards, 255 U. S. 527, 535 ..... 5, 7, 10
Havens v. Fire Insurance Co., 123 Mo. 403, 419 ..... 5, 10
Helvering v. Bruun (C.C.A. 8), 105 F.(2d) 442 ..... 1, 6, 12, 16
Hewitt Realty Co. v. Commissioner (C.C.A. 2), 76 F.(2d) 880 ..... 6, 12, 13, 14, 15
Hilgenberg v. United States (D.C. Md.), 21 F.Supp. 453 ..... 6, 12, 14
Holtgreve v. Sobolewski, 326 Mo. 412, 422 ..... 5, 10
Hughes v. Kershow, 42 Colo. 210 ..... 5, 10
Kentucky Block Coal Co. v. Lucas, 4 F.Supp. 266 ..... 6, 12
Koshland v. Helvering, 298 U. S. 441, 445-446 ..... 5, 10, 20
Martin v. Commissioner, 24 B.T.A. 813 ..... 6, 18
Merchants Loan & Trust Co. v. Smietanka, 255 U. S. 509, 519-520 ..... 4, 7
Miller v. Gearin (C.C.A. 9), 258 Fed. 225 ..... 6, 12
Mount v. Commissioner (C.C.A. 2), 48 F.(2d) 550, 552 ..... 5, 9
Nicholas v. Fifteenth Street Investment Co. (C.C.A. 10), 105 F.(2d) 442 ..... 6, 12, 16
Omaha National Bank v. Commissioner (C.C.A. 8), 75 F.(2d) 434, 436 ..... 5, 11-12
O'Meara v. Commissioner (C.C.A. 10), 34 F.(2d) 390, 395 ..... 5, 9
Palmer v. Commissioner, 305 U. S. 63, 68-69 ..... 5, 11, 21
Rose v. Trust Co. (C.C.A. 5), 28 F.(2d) 767, 776, 778 ..... 5, 11
Rossheim v. Commissioner (C.C.A. 3), 92 F.(2d) 247, 249 ..... 5, 11
Salvage v. Commissioner (C.C.A. 2), 76 F.(2d) 112, 114 20-21
Schoenheit v. Lucas (C.C.A. 4), 44 F.(2d) 476, 479-480 ..... 5, 9
Scott v. Commissioner, 9 B.T.A. 1219 18
Shelton v. Jones, 66 Okla. 83 ..... 5, 10

Slack v. Commissioner, 35 B.T.A. 271, petition for review dismissed (C.C.A. 9), 91 F.(2d) 1011 6, 18
Staples, et al v. United States (D.C. E.D. Pa.), 21 F.Supp. 453 6, 12, 14
Stimson Corp. v. Commissioner, 38 B.T.A. 303, 307 6, 18
Taft v. Bowers, 278 U. S. 470, 482 4, 7
Taplin v. Commissioner (C.C.A. 6), 41 F.(2d) 454 5, 11
United States v. Phellis, 257 U. S. 156, 168-169 4, 7, 9.
United States v. Safety Car Heating & L. Co., 297 U. S. 88, 99 4, 7

Constitution:

Sixteenth Amendment 2, 20

Statutes:

Revenue Act of 1932, c. 209, 47 Stat. 169:
Sec. 22 7

Miscellaneous:

Treasury Regulations 77, promulgated under the Revenue Act of 1932:
Art. 63, as amended by T.D. 4539, XIV-1 C.B. 141 2

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 30) is unreported. The opinion of the Circuit Court of Appeals (R. 43-46) is reported at 105 F.(2d) 442.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 24, 1939 (R. 47), and petition for writ of cer-

tiorari was filed October 21, 1939, and was granted November 22, 1939. The jurisdiction of this Court is conferred by Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question presented is whether a lessor derives income in the year of the cancellation of a lease to the extent of the then value of a building erected by the lessee and forfeited to the lessor upon the termination of the lease because of its breach.

CONSTITUTIONAL AMENDMENT AND STATUTE INVOLVED[1]

Sixteenth Amendment to the Constitution:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1932, Chap. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME

> (a) "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

---

[1]Article 63 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, as amended by T. D. 4539, XIV-1, C. B. 141, was held to be void by this Court in **M. E. Blatt Co. v. United States**, 305 U. S. 267.

STATEMENT OF FACTS

The facts as stipulated (R. 13-15) and found by the Board of Tax Appeals (R. 30) are as follows:

On July 1, 1915, Charles A. Bruun, being then the owner of a parcel of improved real estate located at the southeast corner of Twelfth Street and Grand Avenue, Kansas City, Missouri, leased the same to Newmarket Investment Company for a period of 99 years (R. 14), running from July 1, 1915, and ending June 30, 2014 (R. 16). The lease provided for the payment of rent as follows:

$ 5,000.00 upon the execution of the lease
1,000.00 a month to July 1, 1918
1,666.66 a month to July 1, 1922
2,083.33 a month to July 1, 1925
2,500.00 a month to July 1, 2014 (R. 17)

The lease required the payment of all taxes by the lessee (R. 18), and authorized the lessee to remove or tear down any buildings then, or which might thereafter be placed, upon the premises, provided it should first deliver to the lessor a bond guaranteeing the payment of all rent and the performance of all the conditions of the lease for a period of two years after the beginning of the removal or demolition of such building or buildings (R. 20-21). The lessee was *authorized*, but *not required*, to place new buildings upon the premises (R. 20, 25). The lease provided for forfeiture for failure to pay rent or taxes, and provided that no buildings should be removed from the premises or torn down after forfeiture (R. 21-22, 28), or after the year 2010 (R. 21). It provided that upon termination of the lease the lessee would "yield up to the first party the lands hereby leased with all buildings, improvements, fixtures and appliances situate thereon" (R. 28). The lessee went into possession and during the

latter part of 1929 tore down the old building which then had a depreciated cost to the Respondent of $13,365, and prior to December 31, 1929, it constructed a new building upon the premises which had a useful life of less than 50 years.

On July 1, 1933, the lessee being in default in the payment of rent and taxes, the lease was cancelled and the Respondent went into possession of the property. The building thereon, which had been constructed by the lessee, had a value at that date of $64,245.68. The undepreciated cost of the old building torn down in 1929, amortized to July 1, 1933, was $12,811.43, which sum, when deducted from the $64,245.68, left a balance of $51,434.25 (R. 14). Neither this sum nor any part thereof was reported by the Respondent in his income tax return filed with the Collector of Internal Revenue at Kansas City, Missouri, for the year 1933. Upon auditing Respondent's return, the Commissioner added $51,434.25 to Respondent's gross income and determined a deficiency of $4,111.43 (R. 15).

The Board of Tax Appeals held that no gain was realized from the cancellation of the lease in 1933 (R. 30) and the Circuit Court of Appeals affirmed (R. 46).

SUMMARY OF ARGUMENT

To derive from capital, income taxable under the several Revenue Acts enacted since the adoption of the Sixteenth Amendment, it is essential that there be a growth or increment of value in the property and that this be so severed from the capital and received by the owner as to make it available for his separate benefit and disposal. *Eisner* v. *Macomber*, 252 U. S. 189, 207; *United States* v. *Phellis*, 257 U. S. 156, 168-169; *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519-520; *Taft* v. *Bowers*, 278 U. S. 470, 482; *United States* v. *Safety Car Heating & L. Co.*, 297 U. S. 88, 99. Not only must such severed

increment in value be reduced to possession, but it must be in cash or in such form as to be readily reducible to cash. *Burnet* v. *Logan*, 283 U. S. 404, 413-414; *Commissioner* v. *Wood* (C.C.A. 7), 107 F.(2d) 869; *O'Meara* v. *Commissioner* (C.C.A. 10), 34 F.(2d) 390, 395; *Champlin* v. *Commissioner* (C.C.A. 10), 71 F.(2d) 23, 29; *Schoenheit* v. *Lucas* (C.C.A. 4), 44 F.(2d) 476, 479-480; *Mount* v. *Commissioner* (C. C. A. 2), 48 F.(2d) 550, 552; *Bourn* v. *McLaughlin* (D.C. Cal.), 19 F.(2d) 148, 150. Otherwise, the owner would be required to pay a tax out of capital and an income tax would be converted into a capital levy. This may not be done. *Koshland* v. *Helvering*, 298 U. S. 441, 445-446; *Goodrich* v. *Edwards*, 255 U. S. 527, 535.

Where a lessee constructs a building upon the premises of the lessor the building attaches to and becomes a part of the realty either at the time of its erection (*Holtgreve* v. *Sobolewski*, 326 Mo. 412, 422; see, *Havens* v. *Fire Insurance Co.*, 123 Mo. 403, 419; *Climer* v. *Wallace*, 28 Mo. 556-559), or, as in the instant case, simultaneously with the termination of the lease (*Shelton* v. *Jones*, 66 Okla. 83; *Hughes* v. *Kershow*, 42 Colo. 210). Accordingly, even though the building increases the value of the land, instead of that increase in value being severed from the capital and made available for the taxpayer's separate use and disposal, it attaches to and, for the first time, becomes a part of the capital. It is nothing more than an increment of value in the property. It is not unlike the result of a good bargain, and it is well settled that such a result does not constitute taxable income. *Palmer* v. *Commissioner*, 305 U. S. 63, 68-69; *Rose* v. *Trust Co.* (C.C.A. 5), 28 F.(2d) 767, 776, 778; *Commissioner* v. *VanVorst* (C.C.A. 9), 59 F.(2d) 677, 680; *Taplin* v. *Commissioner* (C.C.A. 6), 41 F.(2d) 454; *Rossheim* v. *Commissioner* (C.C.A. 3), 92 F. (2d) 247, 249; *Omaha National Bank* v. *Commissioner* (C.C.A. 8), 75 F.(2d) 434, 436; *Everhart* v. *Commissioner*, 26 B.T.A. 318; *Geeseman*

v. *Commissioner*, 38 B.T.A. 258, 264, acquiesced in by the Commissioner, C. B. 1939-1, page 13.

These principles have been accepted and applied adversely to the Government's contention by every court dealing with the question whether income accrues to a lessor by reason of the construction of a valuable building upon his property by the lessee (*M. E. Blatt Co.* v. *United States*, 305 U. S. 267; *Commissioner* v. *Center Investment Co.* (C.C.A. 9), 108 F.(2d) 190; *Commissioner* v. *Wood* (C.C.A. 7), 107 F.(2d) 869; *Helvering* v. *Bruun* (C.C.A. 8), 105 F.(2d) 442; *Nicholas* v. *Fifteenth Street Investment Co.* (C.C.A. 10), 105 F.(2d) 289; *Dominick* v. *United States* (D.C. S.D. N.Y.), 24 F.Supp. 829; *English* v. *Bitgood* (D.C. Conn.), 21 F.Supp. 641; *Staples et al* v. *United States* (D.C. E.D. Pa.), 21 F.Supp. 737; *Hilgenberg* v. *United States* (D.C. Md.), 21 F.Supp. 453; *Hewitt Realty Co.* v. *Commissioner* (C.C.A. 2), 76 F.(2d) 880; *Cryan* v. *Wardell* (N.D. Cal.), 263 Fed. 248; *Miller* v. *Gearin* (C.C.A. 9), 258 Fed. 225), with the exception of the Court of Claims in *M. E. Blatt Co.* v. *United States*, 23 F.Supp. 461, and the District Court for the Western District of Kentucky in *Kentucky Block Coal Co.* v. *Lucas*, 4 F.Supp. 266, both of which were overruled by this Court in *M. E. Blatt Co.* v. *United States, supra.*

The Board of Tax Appeals has also consistently held that no income results to a lessor upon cancellation of a lease even though he comes into possession of a valuable building constructed upon the premises by the lessee. *Scott* v. *Commissioner*, 9 B.T.A. 1219; *Alexander* v. *Commissioner*, 13 B.T.A. 1169; *Martin* v. *Commissioner*, 24 B.T.A. 813; *Slack* v. *Commissioner*, 35 B.T.A. 271, petition for review dismissed (C.C.A. 9), 91 F.(2d) 1011; *Durkheimer Investment Co.* v. *Commissioner*, 36 B.T.A. 423; *F. S. Stimson Corp.* v. *Commissioner*, 38 B.T.A. 303, 307; *Cleveland Trust Co.* v. *Commissioner*, 39 B.T.A. 113.

ARGUMENT

Respondent Realized No Taxable Income upon Termination of the Lease

The Sixteenth Amendment to the Constitution authorized Congress "to lay and collect taxes on income from whatever *source derived*." [Italics ours.]

Section 22(a) of the Revenue Act of 1932, so far as here material, defines the term "gross income" as including

> * * * gains, profits and income *derived from* * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * * or gains or profits and income *derived from* any source whatever. [Italics ours.]

In an unbroken line of decisions this Court has consistently held that before income can be said to be "derived from" capital, it is necessary not only that there be a growth or increment of value in the property, but there must be something of exchangeable value severed from the property and received by the taxpayer for his separate use, benefit, and disposal. *Eisner* v. *Macomber*, 252 U. S. 189, 207; *United States* v. *Phellis*, 257 U. S. 156, 168-169; *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519-520; *Taft* v. *Bowers*, 278 U. S. 470-482; *Goodrich* v. *Edwards*, 255 U. S. 527, 535; *United States* v. *Safety Car Heating & L. Co.*, 297 U. S. 88, 99.

In *Eisner* v. *Macomber*, *supra*, this Court had before it the question whether a stock dividend constituted income which could be reached by an income tax statute, and with respect to the essential characteristics of a gain derived from property it said, pages 206-209:

> * * * For the present purpose we require only a clear definition of the term "income" as used in com-

mon speech, in order to determine its meaning in the Amendment; * * *

After examining dictionaries in common use * * * we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of August 5, 1909 * * *: "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case * * *.

Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The Government although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain", which was intended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived,--"*derived--from--capital*";--"*the gain--derived--from--capital*" etc. Here we have the essential matter: *Not* a gain *accruing* to capital, not a *growth* or *increment* of value in the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being "*derived*", that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit, and disposal; *that* is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment. -- "Incomes, *from* whatever *source derived*",--the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Thus, it will be seen that this Court has recognized the import of the phrase "derived from" as used both in the constitutional amendment and in the statute, and has held that before there can be a taxable income "derived from" property there must be a growth or increment of value in the investment and it must be so severed from the capital as to make it available for the taxpayer's

separate use and disposal. This definition of income was reiterated in *United States* v. *Phellis, supra,* wherein this Court had before it the question whether a certain corporate distribution constituted a taxable dividend within the meaning of a statute similar to Section 22(a), *supra.* With regard thereto the Court said, page 169:

> * * * Disregarding the slight looseness of construction, we interpret "gains, profits, and income derived *from* * * * dividends", etc., as meaning not that everything in the form of a dividend must be treated as income, but that income derived *in the way of* dividends shall be taxed. Hence the inquiry must be whether the shares of stock in the new company received by claimant as a dividend by reason of his ownership of stock in the old company constituted * * * a gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested, and coming in,--that is, received or drawn by the claimant for his separate use, benefit, and disposal.

Thus, again we have this Court recognizing that before one can derive income from property he must receive something which may be used and disposed of separate and apart from his capital. The definition of income laid down in these two decisions has been consistently followed, and, so far as we have been able to ascertain, never departed from by this Court.

Applying the rule laid down in these decisions, it has been held that before there can be any taxable gain a consideration must be received and it must be in cash or in such form as to be readily reducible to cash. *Burnet* v. *Logan,* 283 U. S. 404, 413-414; *Commissioner* v. *Wood* (C.C.A. 7), 107 F.(2d) 869; *O'Meara* v. *Commissioner* (C.C.A. 10), 34 F.(2d) 390, 395; *Champlin* v. *Commissioner* (C.C.A. 10), 71 F.(2d) 23, 29; *Schoenheit* v. *Lucas* (C.C.A. 4), 44 F.(2d) 476, 479-480; *Mount* v. *Commissioner* (C.C.A. 2), 48 F.(2d) 550, 552; *Bourn* v. *McLaugh-*

lin (D.C. Cal.), 19 F. (2d) 148, 150. The recipient must have acquired something apart from his capital out of which he can discharge the government exaction. *Commissioner* v. *Wood* (C.C.A. 7), 107 F.(2d) 869, 872. Otherwise, an income tax statute would be converted into a capital levy, and it is well settled that that may not be done. *Koshland* v. *Helvering*, 298 U. S. 441, 445-446; *Goodrich* v. *Edwards*, 255 U. S. 527; 535.

With these fundamental characteristics of income in mind it is pertinent that we turn to a consideration of the nature of the gain, if any, accruing to the lessor upon the forfeiture of a lease where a valuable building has been placed upon the premises by the lessee. It is well settled that in such a case the building attaches to and becomes a part of the realty either at the time of its erection (*Holtgreve* v. *Sobolewski*, 326 Mo. 412, 422; see, *Havens* v. *Fire Insurance Co.*, 123 Mo. 403, 419; *Climer* v. *Wallace*, 28 Mo. 556, 559) or, as in the instant case, simultaneously with the termination of the lease (*Shelton* v. *Jones*, 66 Okla. 83; *Hughes* v. *Kershow*, 42 Colo. 210). Accordingly, in instances where the building actually increases the value of the land, instead of such increment of value being so severed from the capital as to make it available for the taxpayer's separate use and disposal, the result is exactly the converse. The building, instead of being severed from the property, becomes a part of it, and where the improvement is in the form of a store and office building, as manifestly was the situation here,[2] it is a matter of common knowledge that it could not be removed from the premises except by its demolition. A building which is not movable from the premises on which it stands could not be sold or disposed of separate and apart from the land, as any conveyance

[2] This is apparent from the fact that at the time the lease was cancelled, it provided for a rental of $2,500 a month, or $30,000 a year (R. 17) and the building was first appraised by the Revenue Agent at $92,509.92, which appraised value was later reduced by the Commissioner to $64,245.68 (R. 10).

would, by necessary implication, carry with it the right to permit the building to remain upon the land, and such right would, of course, constitute an interest in the realty, the capital of the owner. Accordingly, it follows that instead of the increment of value to Respondent's capital having been severed from the capital, it became attached to and a part of it, and manifestly, it was neither severed from such capital nor severable. Being neither separated nor severable, Respondent received nothing of exchangeable value in the form of cash or its equivalent with which he could pay an income tax.[3] Respondent's position is no different than though he had procured the construction upon his premises of a building worth $64,245.68 at a cost of $12,811.43 (R. 14).[4] He was economically richer by $51,434.25. However, that does not differ from the result of any good bargain, and it is a well settled principle that the results of a good bargain do not constitute taxable income. *Palmer* v. *Commissioner*, 302 U. S. 63, 68-69; *Rose* v. *Trust Co.* (C.C.A. 5), 28 F.(2d) 767, 776, 778; *Commissioner* v. *VanVorst* (C.C.A. 9) 59 F.(2d) 677, 680; *Taplin* v. *Commissioner* (C.C.A. 6), 41 F.(2d) 454; *Rossheim* v. *Commissioner* (C.C.A. 3), 92 F.(2d) 247, 249; *Omaha National Bank* v. *Commissioner*

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[3] While by the stipulation it is agreed that the building had a fair market value of $64,245.68, it was never intended that that should mean any more than that $64,245.68 represented that portion of the fair market value of the building and the land which was properly allocable to the building. This is implicit in the Government's petition for writ of certiorari, wherein it states that the case is of general importance. Manifestly, if the Government had intended to contend that this case should be controlled by a technical construction of an inadvertent phrase contained in the stipulation, which is clearly contrary to well known facts, it could not have represented to this Court that the case was of general importance because in other cases the facts would be made to appear, and appearing they would be at once distinguishable from the instant case. Hence, we assume that the Government will agree that the stipulation with respect to value was intended to mean nothing more than that $64,245.68 represented that part of the fair market value of the land and building which was properly allocable to the building. Such agreements are very common in arriving at a basis for depreciation.

[4] The lessee placed a new building upon the premises in replacement of an old one having a depreciated cost of $12,811.43 (R. 14).

(C.C.A. 8), 75 F.(2d) 434, 436; *Everhart* v. *Commissioner*, 26 B.T.A. 318; *Geeseman* v. *Commissioner*, 38 B.T.A. 258, 264, acquiesced in by the Commissioner, C. B. 1939-1, page 13.

These principles have been recognized and applied by every court before which there has arisen the general question whether a lessor derives taxable income by reason of the construction on his premises of valuable improvements by a lessee,[5] with the exception of the Court of Claims in *M. E. Blatt Co.* v. *United States*, 23 F.Supp. 461, and the District Court for the Western District of Kentucky in *Kentucky Block Coal Co.* v. *Lucas*, 4 F.Supp. 266. The decision in the latter case was devoid of any analysis of the authorities. Both decisions were rejected by this Court in *M. E. Blatt Co.* v. *United States*, 305 U. S. 267.

The first case to reach a court appears to have been *Miller* v. *Gearin* (C.C.A. 9), 258 Fed. 225 (May 5, 1919). Therein, a building was placed upon the leased premises in 1907 and the lease was forfeited in 1916. The Commissioner determined that income resulted to the lessor upon the termination of the lease. The court held to the contrary, saying, page 226:

> The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income.

Petition for writ of certiorari was denied, 250 U. S. 667.

The question was next considered in *Cryan* v. *Wardell* (N.D. Cal.), 263 Fed. 248 (February 2, 1920).

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[5] **M. E. Blatt Co. v. United States**, 305 U. S. 267; **Commissioner v. Center Investment Co.** (C.C.A. 9), 108 F.(2d) 190; **Commissioner v. Wood** (C.C.A. 7), 107 F.(2d) 869; **Helvering v. Bruun** (C.C.A. 8), 105 F.(2d) 442; **Nicholas v. Fifteenth Street Investment Co.** (C.C.A. 10), 105 F.(2d) 289; **Dominick v. United States** (D.C. S.D. N.Y.), 24 F.Supp. 829; **English v. Bitgood** (D.C. Conn.), 21 F.Supp. 641; **Staples et al v. United States** (D.C. E.D. Pa.), 21 F.Supp. 737; **Hilgenberg v. United States** (D.C. Md.), 21 F.Supp. 453; **Hewitt Realty Co. v. Commissioner** (C.C.A. 2), 76 F.(2d) 880; **Cryan v. Wardell** (N.D. Cal.), 263 Fed. 248; **Miller v. Gearin** (C.C.A. 9), 258 Fed. 225.

In that case the building was placed upon the leasehold in 1910 and the lease forfeited in 1916. The court held that whatever accretion in value resulted to plaintiff from the erection of the building in question accrued and became vested in the taxpayer in 1910, and hence that there was no gain upon a termination of the lease.

In *Hewitt Realty Co.* v. *Commissioner* (C.C.A. 2), 76 F.(2d) 880 (April 8, 1935), the question presented was whether the lessor derived income at the time the building was placed upon his land by the lessee. It was found that at the time of the completion of the building it had a fair market value of $559,842.32. However, in holding that no income resulted to the lessor the majority opinion considered and applied the fundamental principles which we have outlined above. It said, page 884:

> * * * We concede that in a situation like that at bar a lessor need not receive money to be taxable; if improvements to land be portable--detachable machinery for example, which he can take off and sell as separate chattels--he receives income either when the lease is made, or when the term ends; for present purposes we need not say which. *On the other hand, if the lease requires the lessee to drain the land, or set out shade trees, or pave it, or grade it, or build a golf course, or a race track on it, we can see no difference between the resulting increase in its value and that arising from the growth of the surrounding neighborhood, or the increase in value of a share of stock. The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.*
>
> * * * Therefore, in our judgment if a building when removed be worthless, save as bricks, iron, and mortar, it becomes income only when the land is sold, and then only in so far as it increases the "amount realized" at that time--the minuend in the equation of gain. This answers every fiscal necessity, far more

directly and simply than any other formula. While the term lasts, the lessor gets nothing which benefits him but the rent; *when it ends, he gets land for which he can get a higher rent*--that is, if the building is neither outworn, nor outmoded. On all rents he must pay a tax. *If he sells at any time, pending the term or after it ends, the building will increase his gains; and his taxes in proportion. But a power to sell is not the same as a sale.* [Italics ours.]

In *Hilgenberg* v. *United States* (D.C. Md.), 21 F.Supp. 453 (November 27, 1937), the question presented was the same as that before the court in *Hewitt Realty Co.* v. *Commissioner*. After reviewing the cases which have been cited above and approving the reasoning of the majority opinion in the *Hewitt Realty Company* case, the court said, page 458:

> The theory underlying the present attitude of the Commissioner and all of the decisions of the Board of Tax Appeals appears to be founded on the misconception that, since the value of the improvements is not income at the time the lease is terminated, it must of necessity be income when they are completed. This, of course, is a *non sequitur*, because it need not be income at either time. * * *

In *Staples, et al* v. *United States* (D.C. E.D. Pa.), 21 F.Supp. 737 (December 31, 1937), the question presented was the same as that presented in each of the two foregoing cases. After a careful review of the decisions of this Court defining income, the court said, page 740:

> In the light of this authoritative definition I have reached the conclusion that the value of a building erected by a tenant on his own initiative and without any obligation to do so, which by reason of its being annexed to the freehold becomes the property of the landlord, is not income of the landlord until the land is sold or otherwise disposed of. * * *
>
> In the present case it seems clear to me that the value of the building permanently added to the land

by the tenant was at the most, in the words of Mr. Justice Pitney, but "a gain accruing to capital, * * * a growth or increment of value in the investment." It was not "something of exchangeable value, proceeding from the property, severed from the capital, * * * and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal."

In *English* v. *Bitgood* (D.C. Conn.), 21 F.Supp. 641 (January 5, 1938), the question again was whether income accrued to the landlord at the time the building was placed upon the premises. The court decided against the Government on the basis of the decision of the court in *Hewitt Realty Company* v. *Commissioner, supra.*

In *Dominick* v. *United States* (D.C. S.D. N.Y.), 24 F.Supp. 829 (January 30, 1938), the court had before it the question here presented, that is, whether gain accrues to the lessor upon the termination of the lease. The court felt that it was bound by the reasoning of the Circuit Court of Appeals in the *Hewitt Realty Company* case and, accordingly, found against the Government.

The question whether gain resulted to the lessor at the time of the construction of a building upon his premises by a lessee finally reached this Court in *M. E. Blatt Co.* v. *United States,* 305 U. S. 267 (December 5, 1938), and, in holding that no gain resulted to the lessor at the time the improvements became his, this Court said, page 279:

> Granting that the improvements increased the value of the building, that enhancement is not realized income of lessor so far as concerns taxable income. The value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; not income within the meaning of the statute.

Thus, this Court in unequivocal language approved the reasoning of the courts rejecting the Government's

contention, and stated that even though improvements placed upon land by a lessee enhance the value of the land such value is not distinguishable from excess of value over cost of improvements made by the owner; each is an addition to capital, and neither constitute taxable income within the meaning of the statute. Language more decisive of the issue here presented could not well be employed.

Following the *Blatt Company* decision, the question whether income accrues to a lessor upon the cancellation of the lease to the extent of the value of improvements made upon the premises by the lessee during his tenancy came before the Circuit Court of Appeals for the Tenth Circuit in *Nicholas* v. *Fifteenth Street Investment Co.*, 105 F.(2d) 289 (June 19, 1939). The court rejected the Government's contention, saying, page 290:

> The improvements for which the lessee paid enhanced the value of the property, but the enhancement did not constitute realized income to the taxpayer during the years in question. It constituted an addition to capital instead of realized income within the meaning of the statute. Such an enhancement in value can result in realized income to the taxpayer only through increased rentals from the property after cancellation of the lease, or through the sale of the property. * * *

This decision was followed by the decision of the Circuit Court of Appeals herein, in *Helvering* v. *Bruun*, 105 F.(2d) 442 (July 10, 1939). After reviewing the authorities the court refused to support the Commissioner's position, saying, page 444:

> Under this rule the taxpayer in the present case is in the same position with respect to income that he would have been had he constructed a building upon his premises in 1933 worth $51,434.25 in excess of cost. Such a building would have added "enhanced" or "excess" value to the real estate in that year; but it would have been only "an addition to capital; not income."

The same question reached the Circuit Court of Appeals for the Seventh Circuit in *Commissioner* v. *Wood*, 107 F.(2d) 869 (November 27, 1939), and in rejecting the Commissioner's contention, the court said, pages 871-872:

> Commissioner's position--that acquisition or possession by the lessor of leasehold improvements made by the lessee and worth $80,000 results in the realization of income--is plausible, but we are not ready to indorse it. To us leasehold improvements may constitute taxable income to the lessor, within the meaning of the taxing statute, only if in a form more definite than a mere acquisition of title or possession, or an increase in value of the property to which they are affixed. That is to say, in our minds leasehold improvements can result in taxable income to the lessor only through increased rentals from the property after cancellation of the lease, or through the sale of the property. * * *
>
> If a taxpayer had constructed a building on his land in 1932 worth $80,000 in excess of cost, he would not have been chargeable with taxable income, although such an improvement would have increased the value of his land. We believe that the taxpayer in the instant case is in no different situation and consequently that he should be treated in the same way. *Moreover, what has the lessor in the instant case received, from which he can pay the tax on* $80,000? Since his income is in the form of a capital asset, he has received nothing with which to pay the tax.
>
> *In such cases, common sense dictates that the taxpayer by necessity must wait for his income until there is a conversion into cash or its substantial equivalent.* See *Eisner* v. *Macomber*, 252 U. S. 189, 207, 208, * * * Nor does such a construction of the taxing statute work a disadvantage to the Government. The Government will collect its tax, if the taxpayer sells or exchanges the property. On the other hand, if the taxpayer elects to hold the property upon repossession, the Government will tax the entire earnings therefrom, as long as the building is valuable enough to produce net income. [Italics ours.]

In *Commissioner* v. *Center Investment Company*, 108 F.(2d) 190 (November 27, 1939), the Circuit Court of Appeals for the Ninth Circuit reaffirmed its decision in *Miller* v. *Gearin, supra*, saying, page 191:

> We are of the view that no such change in kind or extent of the taxpayer's rights was occasioned by the forfeiture as to constitute a "severance" or "realization" of income. * * *
>
> * * * Any increase in value accruing to that asset in the year of forfeiture of the lease constituted increase in economic worth but not realized income. * * *

The Board of Tax Appeals has likewise been consistent in holding that no gain accrues to a lessor upon the termination of a lease, even though the lessee has constructed a valuable building thereon.[6]

Cleveland Trust Co. v. *Commissioner*, 39 B.T.A. 113, was decided after the decision of this Court was handed down in the *Blatt Company* case. The Board reaffirmed its position, saying:

> * * * However, in the *Blatt* case, *supra*, the Supreme Court considered the validity of that regulation. It is true the Court there had to decide only "whether, under the lease here involved, one-tenth of what the commissioner and taxpayer call and agree to be 'estimated depreciated value,' as of the end of the term, was income to petitioner in the first year of the term." But, in disposing of that question on the facts there before the Court, the majority opinion clearly invalidates the regulation under which the respondent acted here, and says:
>
> "Granting that the improvements increased the value of the building, the enhancement is not realized income of lessor. So far as concerns taxable in-

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[6] **Scott v. Commissioner**, 9 B.T.A. 1219; **Alexander v. Commissioner**, 13 B.T.A. 1169; **Martin v. Commissioner**, 24 B.T.A. 813; **Slack v. Commissioner**, 35 B.T.A. 271, petition for review dismissed (C.C.A. 9), 91 F.(2d) 1011; **Durkheimer Investment Co. v. Commissioner**, 36 B.T.A. 423; **F. S. Stimson Corp. v. Commissioner**, 38 B.T.A. 303, 307; **Cleveland Trust Co. v. Commissioner**, 39 B.T.A. 113.

come, the value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; not income within the meaning of the statute. Treasury Regulations can add nothing to income as defined by Congress."

In view of that unequivocal expression by the Supreme Court, we now hold that where, as here, the improvements to the leasehold do not constitute rent and, when constructed, became a part of the leased premises, and if removed, had only a salvage value, no taxable income is realized by their lessor upon its acquisition of possession of such premises at the termination of the lease.

Thus, we have an unbroken line of decisions of this Court holding that before income can be said to be derived from capital it is necessary not only that there be a growth or increment of value in the property, but there must be something of exchangeable value *severed* from the property and received by the taxpayer for his *separate use, benefit,* and *disposal,* and, with the two exceptions noted above, we also have an unbroken line of decisions of the courts running from May 5, 1919, down to the present date, applying that definition of income to the question whether taxable income accrues to a lessor by reason of valuable improvements being placed upon his land by a lessee, and in each instance reaching a negative conclusion. The Board of Tax Appeals has also been consistent in its holding that no income results to a lessor under facts such as those here presented. We respectfully submit that those decisions are sound.

It is difficult to understand how this Court can reach a different conclusion without radically changing the definition of income as that term is used in the Sixteenth Amendment to the Constitution, and in all of the Revenue Acts adopted since that time and as it has come to be well understood in the general administration of the income tax statutes. If the Government should prevail in procuring the decision it seeks, instead of clarifying

the income tax laws it will throw the entire structure of the statutes into confusion and give rise to new and endless litigation.

Petitioner contends that the tax is valid, even though that which is sought to be taxed does not constitute income within the meaning of that term as used in the Sixteenth Amendment to the Constitution (Br. 23-25). He says:

> * * * However, it seems clear that a tax upon such gain is valid wholly apart from the Sixteenth Amendment since it is not a direct tax. And in any event the tax is valid since the Sixteenth Amendment was intended "to get rid of nice questions as to what might be direct taxes". * * *

The manifest fallacy of this argument is, first, that in the enactment of all of the income tax laws since 1913, Congress has very obviously intended to exercise only the powers granted to it by the Sixteenth Amendment; second, the several cases of this Court referred to above had to do with a definition of income under statutes practically identical to Section 22(a) of the Revenue Act of 1932; and third, the tax is what it purports to be, an *income* tax, and, as we have stated above, such a tax cannot be converted into a capital levy (*Koshland* v. *Helvering*, 298 U. S. 441, 445-446) or some other form of tax other than that which Congress intended it to be. Manifestly, we are not concerned with that which Congress might have done. Our concern is with that which Congress did.

Petitioner also contends (Br. 14-15):

> * * * Indeed, even the *purchase* of property at a price substantially less than its fair market value may, under certain circumstances, be treated as an income producing transaction.

The difficulty with this contention is, first, that it is not supported by the authorities cited. *Salvage* v. *Com-*

missioner (C.C.A. 2), 76 F.(2d) 112, 114, merely holds that under the particular facts of that case the difference between the fair market value of the stock received and the $150,000 paid therefor constituted consideration to the purchaser "for his covenant not to compete". Manifestly, any money or its equivalent in cash paid to a person "for his covenant not to compete" with another would constitute income. That is a far cry from "the *purchase* of property at a price substantially less than its fair market value". In the case of *Elverson Corp.* v. *Commissioner*, 40 B.T.A. 614, the Board held that the taxpayer had exchanged certain notes for shares of stock "enhanced in value by the morning and Sunday editions of the Public Ledger", and that gain resulted to the taxpayer measured by the difference between the cost of the notes and the cash equivalent of the property it received in exchange. The situation was no different in that case than in any case where there is an exchange of property for other property having a value readily convertible into cash.

The second and fatal difficulty with Petitioner's contention is that it has been flatly rejected by this and other courts. *Palmer* v. *Commissioner*, 302 U. S. 63, 68-69, and see other cases cited at page 13, *supra*.

The Petitioner cites (Br. 14) numerous cases holding that income may be received in the form of property. However, an examination of those cases will disclose that in each instance the taxpayer received property which was separately disposable and readily convertible into cash. They have no bearing upon the issue here presented.

Conclusion

The Petitioner has failed to cite any case which has not been either overruled or rejected, which supports the sought departure from the principles laid down and followed by this Court ever since *Eisner* v. *Macomber*, *supra*.

On the other hand, we have shown that this Court has consistently followed that decision and held that in order to derive taxable income from capital there must be, first, an increment of value in the capital, and second, such a severance of that increment of value as to make it subject to the separate use and disposal of the owner. The taxpayer must have received something separate and apart from his capital out of which he can pay his tax. We have shown that by a unanimity of opinion seldom found in dealing with any supposedly controversial question, both the courts and the Board of Tax Appeals have applied these general principles to facts similar to those here presented, and have held that no taxable gain results to the lessor. Those decisions are consonant with principles weighed in the test of time accepted by Congress and by common judgment approved. Their overthrow would result in endless confusion. The decision below invalidating the tax should be affirmed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 479.—October Term, 1939.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. Charles A. Bruun. | On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[March 25, 1940.]

Mr. Justice Roberts delivered the opinion of the Court.

The controversy had its origin in the petitioner's assertion that the respondent realized taxable gain from the forfeiture of a leasehold, the tenant having erected a new building upon the premises. The court below held that no income had been realized.[1] Inconsistency of the decisions on the subject led us to grant certiorari.

The Board of Tax Appeals made no independent findings. The cause was submitted upon a stipulation of facts. From this it appears that on July 1, 1915, the respondent, as owner, leased a lot of land and the building thereon for a term of ninety-nine years. The lease provided that the lessee might, at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

In 1929 the tenant demolished and removed the existing building and constructed a new one which had a useful life of not more than fifty years. July 1, 1933, the lease was cancelled for default in payment of rent and taxes and the respondent regained possession of the land and building.

The parties stipulated "that as at said date, July 1, 1933, the building which had been erected upon said premises by the lessee had a fair market value of $64,245.68 and that the unamortized cost of the old building, which was removed from the premises in 1929

[1] Helvering v. Bruun, 105 F. (2d) 442.

to make way for the new building, was $12,811.43, thus leaving a net fair market value as at July 1, 1933, of $51,434.25, for the aforesaid new building erected upon the premises by the lessee."

On the basis of these facts, the petitioner determined that in 1933 the respondent realized a net gain of $51,434.25. The Board overruled his determination and the Circuit Court of Appeals affirmed the Board's decision.

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917 the Treasury ruled that the adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease.[2] The ruling was incorporated in two succeeding editions of the Treasury Regulations.[3] In 1919 the Circuit Court of Appeals for the Ninth Circuit held in *Miller* v. *Gearin*, 258 Fed. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.[4]

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned.[5]

In 1935 the Circuit Court of Appeals for the Second Circuit decided in *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the land, and if removed would be worthless except as bricks, iron, and mortar. It said (p. 884): "The question as we

[2] T. D. 2442, 19 Treas. Dec. Int. Rev. 25.

[3] Regulations 33 (1918 Ed.) Art. 4, ¶ 50; Regulations 45 (2d 1919 Ed.) Art. 48.

[4] This court denied certiorari, 250 U. S. 667.

[5] T. D. 3062, 3 Cum. Bull. 109; Regulations 45 (1920 Ed.), Art. 48; Regulations 62, 65, and 69, Art. 48; Regulations 86, 94, and 101, Art. 22(a) —13.

view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away."

This decision invalidated the regulations then in force.[6]

In 1938 this court decided *M. E. Blatt Co. v. United States*, 305 U. S. 267. There, in connection with the execution of a lease, landlord and tenant mutually agreed that each should make certain improvements to the demised premises and that those made by the tenant should become and remain the property of the landlord. The Commissioner valued the improvements as of the date they were made, allowed depreciation thereon to the termination of the leasehold, divided the depreciated value by the number of years the lease had to run, and found the landlord taxable for each year's aliquot portion thereof. His action was sustained by the Court of Claims. The judgment was reversed on the ground that the added value could not be considered rental accruing over the period of the lease; that the facts found by the Court of Claims did not support the conclusion of the Commissioner as to the value to be attributed to the improvements after a use throughout the term of the lease; and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act.

The circumstances of the instant case differentiate it from the *Blatt* and *Hewitt* cases; but the petitioner's contention that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled title, possession and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the *Miller* case and to the reasoning in the *Hewitt* case.

The respondent insists that the realty,—a capital asset at the date of the execution of the lease,—remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or treated as received in exchange for the improvements

[6] The Hewitt case was followed in Hilgenberg v. United States, 21 F. Supp. 453, Staples v. United States, 21 F. Supp. 737, and English v. Bitgood, 21 F. Supp. 641.

which were on the land at the date of the execution of the lease; that they are, therefore, in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner's disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment and may not, therefore, be taxed without apportionment.

We hold that the petitioner was right in assessing the gain as realized in 1933.

We might rest our decision upon the narrow issue presented by the terms of the stipulation. It does not appear what kind of a building was erected by the tenant or whether the building was readily removable from the land. It is not stated whether the difference in the value between the building removed and that erected in its place accurately reflects an increase in the value of land and building considered as a single estate in land. On the facts stipulated, without more, we should not be warranted in holding that the presumption of the correctness of the Commissioner's determination has been overborne.

The respondent insists, however, that the stipulation was intended to assert that the sum of $51,434.25 was the measure of the resulting enhancement in value of the real estate at the date of the cancellation of the lease. The petitioner seems not to contest this view. Even upon this assumption we think that gain in the amount named was realized by the respondent in the year of repossession.

The respondent can not successfully contend that the definition of gross income in Sec. 22(a) of the Revenue Act of 1932[7] is not broad enough to embrace the gain in question. That definition follows closely the Sixteenth Amendment. Essentially the respondent's position is that the Amendment does not permit the taxation of such gain without apportionment amongst the states. He relies upon what was said in *Hewitt Realty Co.* v. *Commissioner*, *supra*, and upon expressions found in the decisions of this court dealing with the taxability of stock dividends to the effect that gain derived from capital must be something of ex-

[7] c. 209, 47 Stat. 169, 178.

changeable value proceeding from property, severed from the capital, however invested or employed, and received by the recipient for his separate use, benefit, and disposal.[8] He emphasizes the necessity that the gain be separate from the capital and separately disposable. These expressions, however, were used to clarify the distinction between an ordinary dividend and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder's interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here.

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction.[9] The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

Judgment reversed.

The CHIEF JUSTICE concurs in the result in view of the terms of the stipulation of facts.

Mr. Justice MCREYNOLDS took no part in the decision of this case.

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[8] See Eisner v. Macomber, 252 U. S. 189, 207; United States v. Phellis, 257 U. S. 156, 169.

[9] Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 268 U. S. 536; Old Colony Trust Co. v. Commissioner, 279 U. S. 716; United States v. Kirby Lumber Co., 284 U. S. 1; Helvering v. American Chicle Co., 291 U. S. 426; United States v. Hendler, 303 U. S. 564.